

SAAS IS TAXABLE IN ARIZONA DESPITE NO STATUTORY AUTHORITY TO TAX DIGITAL SERVICES

By Pat Derdenger and Karen Lowell on 09/18/2023

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- On September 12, the Arizona Supreme Court declined to take review in *ADP, LLC v. Ariz. Dep't of Revenue*, No. CV-23-0036-PR., which lets stand the Arizona Court of Appeals opinion in the same case. 254 Ariz. 417, No. 1 CA-TX 21-0009 (Ariz. Ct. App. Jan. 31, 2023).
- This is significant because the Arizona Department of Revenue now has the court's blessing to tax software-as-a-service ("SaaS") transactions as sales or rentals of tangible personal property despite no clear Arizona statutory authority to tax digital goods and services.



ADP involved the taxability of the company's "eTime" software application, which was leased to Maricopa County. County employees were able to enter their time and other employment data into eTime via the web. Once entered, eTime collected and processed the data. Arizona imposes a transaction privilege tax (i.e., sales tax) on rentals of "tangible personal property." See A.R.S. § 42-5071. At issue in *ADP* was whether the eTime software was "tangible personal property," which under Arizona law includes "personal property that may be seen, weighed, measured, felt or touched or that is in any other manner perceptible to the senses." A.R.S. § 42-5001(21) (emphasis added).

The Arizona Court of Appeals relied on decades-old case law to support its conclusion that eTime is taxable, analogizing the use of eTime to inserting a coin in a jukebox to play a record and the use of a coin-operated laundry machine, both taxable transactions, to conclude that eTime was subject to the transaction privilege tax as a rental of tangible personal property. The cases on which the Arizona Court of Appeals relied – *State v. Jones*, 60 Ariz. 412 (1943) (music played by a jukebox is tangible personal property) and *State Tax Commission v. Peck*, 106 Ariz. 394 (1970) (use of a coin operated washing machine is a rental) – are 80 and 53 years old, respectively.

By declining review, the Arizona Supreme Court lets the Court of Appeals decision stand as law in Arizona. This result arguably gives the Arizona Department of Revenue almost unbounded discretion to determine what is "perceptible to the senses" and therefore subject to tax. *ADP* offers no clear limiting principle for the interpretation of this phrase. Among 23 states that impose sales tax on SaaS, Arizona is an outlier – it is one of only three states that tax SaaS without any clear statutory authority. See *COST, Best and Worst of State Sales Tax System* (December 2022), available [here](#).

SaaS is Taxable in Arizona Despite No Statutory Authority to Tax Digital Services

It would also arguably allow the Department of Revenue leeway to tax formerly nontaxable services merely because those services have been automated. See *ADP, LLC v. Arizona Dep't of Revenue*, 254 Ariz. 417, ¶ 28 (Ct. App. 2023): “ADP manually processed its customers’ payroll; now, ADP licenses eTime to its customers, and eTime automates the [nontaxable] labor that ADP previously provided ... The charging of fees to use eTime software that automates its HR work fundamentally altered ADP’s business, thereby warranting a change in taxation that is not discriminatory.”

Will the Arizona Legislature act to reverse the *ADP* case?

If you have questions on SaaS tax in the state of Arizona, please contact **Pat Derdenger** or **Karen Lowell**.

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